(1)

No. 95-325

In The

Supreme Court of the United States

October Term, 1995

UNITED STATES OF AMERICA,

Petitioner,

vs.

REORGANIZED CF&I FABRICATORS OF UTAH, INC., *et al.*,

Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

BRIEF FOR RESPONDENTS REORGANIZED CF&I FABRICATORS OF UTAH, INC., *et al.*

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QUESTIONS PRESENTED

1. Whether the Bankruptcy Code's priority for "an excise tax on a transaction occurring . . . [,]" 11 U.S.C. § 507(a)(7)(E)(i),[1] extends to a claim under 26 U.S.C. § 4971(a), labeled as a "tax" but imposed as a penalty for failing to make required pension plan contributions and not in compensation for any actual pecuniary loss to the Internal Revenue Service?

2. Whether a claim for a nonpecuniary loss penalty in a liquidating Chapter 11 case may be given a lower distributive priority than the claims of general unsecured creditors who suffered actual pecuniary losses, under (a) 11 U.S.C. §§ 510(c)(1) and 502(j) or (b) 11 U.S.C. §§ 1122(a), 1123(a)(1), 1123(a)(4), 1129(a)(7)(A) and 1129(b)(1)?

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[1] Under the Bankruptcy Reform Act of 1994, the priority for certain excise tax claims has been changed from 11 U.S.C. § 507(a)(7)(E) to 11 U.S.C. § 507(a)(8)(E). Pub. L. No. 103-394, § 304(c), 108 Stat. 4106, 4132 (Oct. 22, 1994). That amendment does not affect this case and, for consistency, this brief cites the excise tax priority as 11 U.S.C. § 507(a)(7)(E).

RULE 29.6 STATEMENT

On November 7, 1990, when Respondents filed bankruptcy, CF&I Steel Corporation was a publicly held company and owned all of the stock of its nine subsidiaries: CF&I Fabricators of Utah, Inc., Colorado & Utah Land Company, Kansas Metals Company, Albuquerque Metals Company, Pueblo Metals Company, Denver Metals Company, Pueblo Railroad Service Company, CF&I Fabricators of Colorado, Inc., and Colorado and Wyoming Railway Company.

On March 3, 1993, the effective date of the liquidating Chapter 11 plan, all interests of stockholders were canceled, including the interests of CF&I Steel Corporation as sole stockholder of each of the other corporate debtors. (Pet. 24a). Accordingly, Respondents are no longer "a corporation and nine subsidiaries." (IRS Br. 2). Respondents (some of whose names were amended to add "Reorganized") are ten separate corporate shells without shareholders and without elected officers or directors and are managed by a representative of creditors under governance provisions approved by the Bankruptcy Court. (Pet. 36a). That representative is Scott C. King. Respondents' correct names are: Reorganized CF&I Fabricators of Utah, Inc., Colorado & Utah Land Company, Kansas Metals Company, Albuquerque Metals Company, Reorganized Pueblo Metals Company, Denver Metals Company, Reorganized Pueblo Railroad Service Company, Reorganized CF&I Fabricators of Colorado, Inc., Reorganized CF&I Steel Corporation, and The Reorganized Colorado & Wyoming Railway Company.

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Statutes Cited:

Page

Other Authorities Cited:

No. 95-325

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UNITED STATES OF AMERICA,
PETITIONER,
v.

REORGANIZED CF&I FABRICATORS OF UTAH, INC., et al.,

RESPONDENTS.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR RESPONDENTS REORGANIZED CF&I FABRICATORS OF UTAH, INC., et al.

STATUTES INVOLVED

The relevant portions of 11 U.S.C. §§ 502(j), 507(a)(7)(E), 507(a)(7)(G), 510(c), 1122, 1123(a), 1129(a)(7) and 1129(b)(1), and 26 U.S.C. §§ 412 and 4971(a) are set forth in the appendix to the Respondents' Brief in Opposition to Certiorari. (Opp. 7a-14a).[2]

[2] This brief will employ the following abbreviations in its citation of documents: "Pet." = Petition for Writ of Certiorari; "Opp." = Respondents' Brief in Opposition to Certiorari; "Pet. Rep." = Reply Brief for the United States on Certiorari; "IRS Br." = Brief for the United States; "PBGC Br." = Brief of the Pension Benefit Guaranty Corporation.

Pursuant to Rule 26.7 of the Rules of the Supreme Court and the Court's order dispensing with the requirement of a joint appendix in this case, citations to the record will be to the parties' appendices filed in the

(continued...)

STATEMENT OF THE CASE

Respondents (the "Reorganized Debtors") are ten bankrupt corporations liquidating their assets for the benefit of creditors pursuant to a confirmed plan of reorganization (the "Plan") under Chapter 11 of the United States Bankruptcy Code, 11 U.S.C. §§ 101-1330 (the "Bankruptcy Code"). (Pet. 22a-37a).[3] Proceeds of the liquidation have been and will be distributed to creditors under the direction of a representative of creditors. (*Id.*). The interests of former stockholders have been canceled and stockholders will receive nothing. (Opp. 3a-4a).

The Pension Plans. The Reorganized Debtors' predecessors, CF&I Steel Corporation ("CF&I") and its nine wholly-owned subsidiaries (all ten predecessor corporations are referred to as the "Debtors"), operated a steel plant in Pueblo, Colorado, and related businesses in Colorado, Utah, Kansas, and New Mexico. (CF&I R. 158-76). CF&I sponsored two qualified pension plans for the Debtors' employees and retirees (the "Pension Plans") (CF&I R. 6-8; IRS R. 32) and, as plan sponsor, was required by statute to meet minimum funding standards set by the Employee Retirement Income Security Act, 29 U.S.C. §§ 1001-1461 ("ERISA") and by the Internal Revenue Code, 26 U.S.C. §§ 1-9722. *See* 29 U.S.C. § 1082; 26 U.S.C. § 412(c)(11)(A). Annual minimum funding payments were due each September 15th for the preceding plan year. (Pet. 41a). Failure to meet this deadline would result in an "accumulated funding deficiency" in CF&I's plan accounts. 26 U.S.C. § 412(a).

[2](...continued)
court below, as follows: "IRS R." = Appellant's Appendix (item nos. 21, 15 and 15 on the Court of Appeals' docket nos. 94-4034, 94-4035 and 94-4036, respectively); "CF&I R." = Appellees' Appendix (item nos. 18, 21 and 21 on docket nos. 94-4034, 94-4035 and 94-4036, respectively).

[3] Chapter 11 of the Bankruptcy Code expressly authorizes liquidating plans. 11 U.S.C. § 1123(a)(5)(D).

Due to large losses in its steel business, CF&I could not pay its 1989 minimum funding payments totaling approximately $12.4 million, which came due on September 15, 1990. (CF&I R. 178). Both prior to and after filing under Chapter 11 on November 7, 1990 (the "Petition Date"), CF&I asked the Pension Benefit Guaranty Corporation (the "PBGC") to terminate the larger Pension Plan (the "Master Plan").[4] CF&I's request was denied until March 19, 1992, when the PBGC terminated the Master Plan. (CF&I R. 33-34).

Funding payments owed for retirees' pensions earned before the Petition Date were prepetition debts. Therefore, after the Petition Date, the Debtors by law could not correct the 1989 funding deficiencies or make any further pension funding payments except under a confirmed plan of reorganization. *PBGC v. LTV Corp.*, 875 F.2d 1008, 1019 (2d Cir. 1989), *rev'd on other grounds*, 496 U.S. 633 (1990); (CF&I R. 17-19; Pet. 51a). The Debtors continued to pay prepetition retiree health benefits after the Petition Date as required by 11 U.S.C. § 1114(e).

The PBGC's Claims. When a pension plan is terminated, the PBGC pays to retirees the guaranteed portion of the pension benefits which the PBGC funds out of insurance premiums paid by the plan sponsors and from assets collected from the terminated plan. (PBGC Br. 6). Guaranteed pension benefits are not paid from collection of taxes or out of general federal revenues. H.R. Rep. No. 1280, 93rd Cong., 2d Sess. 366 (1974) ("[T]he [guaranty] funds may draw upon the general funds of the Treasury

[4] The PBGC incorrectly states that CF&I did not take "any steps to terminate" the Pension Plans. (PBGC Br. 8). The Bankruptcy Court found to the contrary: "The Debtors attempted to persuade the PBGC into terminating the Master Plan both before and after filing the chapter 11 petitions." (Pet. 42a). Only the PBGC could unilaterally terminate the Pension Plans under 29 U.S.C. § 1342(c) because a collective bargaining agreement required maintenance of the Pension Plans by the Debtors. *See* 29 U.S.C. § 1341(a)(3); 11 U.S.C. § 1113(f).

only to the extent of their borrowing authority. The funds are to be self-sufficient and are not to be a charge on the Federal budget.").

The Bankruptcy Court initially allowed the PBGC's general unsecured claims for unfunded pension benefits in this case in an amount exceeding $220 million. *PBGC v. Reorganized CF&I Fabricators of Utah, Inc.* (*In re CF&I Fabricators of Utah, Inc.*), 179 B.R. 704, 706 (D. Utah 1994). On November 27, 1995, the Bankruptcy Court reduced the PBGC's general unsecured claims to approximately $122.5 million. *In re CF&I Fabricators of Utah, Inc.*, 19 Employee Benefits Cas. 2371 (BNA) (Bankr. D. Utah 1995). The PBGC has appealed that order. Except for approximately $2 million paid as priority claims, the PBGC's claims were treated as general unsecured claims in the Plan. (CF&I R. 9, 24, 189-90; IRS R. 33). These claims *included* all unpaid minimum funding contributions for the Pension Plans. (CF&I R. 10, 138, 220-39). Payments on the PBGC's claims will in part reimburse the PBGC and in part go to retirees to pay retirement benefits not covered by the PBGC's guaranty limits. Under a statutory allocation formula, the PBGC, as successor trustee of the Master Plan (Pet. 42a), has a statutory duty to grant a share of its own recovery for retirees' nonguaranteed benefits. 29 U.S.C. § 1322(c).

The IRS' Claims. As part of ERISA, Congress added 26 U.S.C. § 4971 ("Section 4971") to the Internal Revenue Code to discourage and penalize pension plan underfunding. H.R. Rep. No. 807, 93rd Cong., 2d Sess. 28 (1974); S. Rep. No. 383, 93rd Cong., 1st Sess. 24-25 (1973). Section 4971 imposes two tiers of exactions on the plan sponsor based on a percentage of the total accumulated funding deficiency of the pension plan: a 10% "tax" under Section 4971(a) (first tier "tax") and a 100% "tax" under Section 4971(b) (second tier "tax"). The 10% first tier "tax" is imposed immediately upon the employer's failure to remit the minimum funding payment by the deadline. 26 U.S.C. § 4971(a). Thereafter, if the sponsoring employer does not "correct" the

deficiency, the 100% second tier "tax" is imposed. 26 U.S.C. § 4971(b).

The Section 4971 "taxes" totaling 110% are imposed as penalties *in addition to* liability for the underlying minimum funding payment which may be collected from the employer by the PBGC. S. Rep. No. 383, 93rd Cong., 1st Sess. 24-25 (1973). If the Section 4971 "taxes" are paid to the IRS, they become general revenues in the United States Treasury and do not reimburse any loss of the PBGC, the pension plans, or the retirees. 26 U.S.C. § 7809.

The IRS' tactic of accumulating 10% and 100% claims in this case confirms that the claims were penalties. The IRS initially filed the following claims against the Debtors for amounts allegedly owing under (i) Section 4971(a) for CF&I's failure to make the 1989 minimum funding payment of $12,416,638 and (ii) Section 4971(b) for the Debtors' failure to make postpetition payments during their bankruptcy to correct the accumulated funding deficiency for 1989 (CF&I R. 3-4; IRS R. 26-27, 34-37):

Pension Plan	10% "Tax"	100% "Tax"
Noncontributory	$ 36,577	$ 365,766
Master	$1,205,047	$12,050,472
Total	$1,241,624	$12,416,238

The IRS asserted priority under 11 U.S.C. § 507(a)(7)(E) (excise taxes) and 11 U.S.C. § 507(a)(7)(G) (pecuniary loss penalties) (now codified at 11 U.S.C. § 507(a)(8)(G)).

The Pension Plans' minimum funding payments for 1990, in the amount of approximately $13,207,897, were due September 15, 1991, nearly a year after the Petition Date. (IRS R. 26-27, 35-37). Because these payments to the Pension Plans were prepetition obligations, CF&I was prohibited from making them. (Pet. 51a). Nevertheless, according to the IRS, the combined accumulated funding deficiency for 1989 and 1990 was $25,624,135, *i.e.*, $12,416,238 for 1989 *plus* $13,207,897 for 1990. (IRS R. 26-27, 35-37). Amounts assessed under Section

4971 are cumulative; "taxes" for 1990 are calculated on the *combined* underfunding for 1989 and 1990. 26 U.S.C. §§ 412(a), 4971(c).

The IRS amended its proofs of claim to include both Section 4971(a) and Section 4971(b) "taxes" of $2,562,413 and $25,624,135, respectively. Therefore, this additional claim was for approximately a 220% "tax" for failure to make the 1990 payment. The claim for 1990 when added to the claim for 1989 "taxes" totaled $41,844,410. (IRS R. 26-29). The "tax" for the 1991 payment would be 330% and so on. In the Bankruptcy Court, the IRS argued alternatively that the Section 4971 claims were entitled to priority as secured claims, excise tax claims and pecuniary loss penalties and, furthermore, that all of its claims except for a prepetition 10% penalty for 1989 were postpetition "administrative taxes" with first priority under Sections 503(b)(1)(B)(i) and 507(a)(1) of the Bankruptcy Code. (Pet. 43a-45a).

Debtors' Objections to the IRS' Claims. The Debtors filed a claim objection requesting that the Bankruptcy Court determine that, although Section 4971 may be a "tax" for purposes of collection and enforcement under the Internal Revenue Code, any allowed claims were, for purposes of priority under the Bankruptcy Code, nonpecuniary loss penalties not entitled to tax priority. (IRS R. 1-13). Simultaneously, the Debtors filed an adversary complaint requesting that the Bankruptcy Court subordinate the Section 4971 claims to the claims of general unsecured creditors who suffered actual pecuniary losses. (IRS R. 14-24). The IRS relied solely on the word "tax" contained in Section 4971 and the subtitle heading "Miscellaneous Excise Taxes" under which Section 4971 is codified as being conclusive of entitlement to priority as an "excise tax on a transaction" under the Bankruptcy Code. The lower courts found that the IRS' claims were not for any pecuniary loss (Pet. 6a, 18a, 47a, 52a, 62a; Opp. 3a) and the IRS has not questioned that finding of fact. (CF&I R. 45-56; Pet. 14a, 47a).

The Bankruptcy Court denied the priorities claimed by the IRS and disallowed postpetition portions of the claims in a Memorandum Decision and Order dated November 25, 1992, published as *In re CF&I Fabricators of Utah, Inc.*, 148 B.R. 332 (Bankr. D. Utah 1992). (Pet. 38a-62a). The Bankruptcy Court ruled that, although the IRS asserted its claims as "excise taxes," these claims were nonpecuniary loss penalties for purposes of priority in bankruptcy. (Pet. 61a-62a).[5]

The Plan of Reorganization. Under the Plan, all assets of the Debtors have been or will be sold and the proceeds, less costs of administration, will be distributed to creditors. Recovery for general unsecured claims is estimated at less than ten cents on the dollar. (CF&I R. 134-41, 202-18, 537). No property will revest in the Reorganized Debtors. After Plan consummation, the Reorganized Debtors will be empty corporate shells with no assets and no stockholders. (CF&I R. 148).

The Plan, under agreements negotiated with the PBGC and other creditors, established Classes 11, 12, 13 and 14 for general unsecured creditors. (CF&I R. 95-101, 137-41, 196-200). Class 11 is an administrative convenience class of the type authorized by 11 U.S.C. § 1122(b). (CF&I R. 95-96, 137, 196-97). Class 12 includes all nonpriority general unsecured claims (including the PBGC's unsecured claims) not included in Classes 11, 13 and 14. (CF&I R. 96-101, 137-41, 197-200). All allowed claims in Class 11 and Class 12 are claims for actual pecuniary losses. (CF&I R. 129, 137-41).

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[5] The Bankruptcy Court did not state that Section 4971's tax label should be "disregarded." (IRS Br. 5). The Court stated that the label was "not controlling." (Pet. 49a). The Court disallowed all postpetition claims under Section 4971 because the Bankruptcy Code prohibited the Debtors from paying the minimum funding payments. (Pet. 53a-54a, 62a).

Class 13 includes the IRS' claims under Section 4971 and all other claims for nonpecuniary loss penalties. (CF&I R. 101, 141, 200). Class 14 includes all general unsecured claims of the Debtors against each another. (*Id.*). Since holders of general unsecured claims in Class 12 will not be paid in full, there will be no distributions under the Plan to holders of claims subordinated in Classes 13 and 14. (CF&I R. 101, 141, 208-18). Any priority payment to the IRS for its Section 4971 claims would reduce, dollar for dollar, distributions to holders of general unsecured claims who suffered pecuniary losses. (Opp. 4a).[6]

The Debtors' Plan, which expressly subordinated the IRS' Section 4971 claims in Class 13, was overwhelmingly approved by creditors. (CF&I R. 260-269). Although the PBGC now joins the IRS in its arguments, the PBGC filed ten ballots accepting the Plan and filed a written statement in support of the Plan. (CF&I R. 139-140, 266).

Confirmation of the Plan. At the January 27, 1993 confirmation hearing, the Debtors presented uncontroverted evidence that the Plan was proposed in good faith and in compliance with the Bankruptcy Code (CF&I R. 304, 313), that creditors would receive under the Plan at least as much as they would receive if the Debtors were liquidated under Chapter 7 (CF&I R. 305, 315-16), that the Debtors had not achieved profitable operations in bankruptcy (CF&I R. 311), that a "stand-alone" plan under which the Debtors would continue to operate was not viable (CF&I R. 311-12), that the sale of major steel making assets to an affiliate of Oregon Steel Mills, Inc. was the most viable alternative for reorganization (*id.*), that the sale of

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[6] The Plan of Reorganization also provided for the full funding and standard termination of the smaller Pension Plan (the "Noncontributory Plan"). (CF&I R. 143, 577-78). Under provisions of the Plan of Reorganization not appealed by the IRS, all claims relating to the Noncontributory Plan, including the IRS' claims of some $36,577 (Pet. 44a), are deemed satisfied and are no longer at issue. (CF&I R. 143).

major assets was proposed in good faith and for a fair price (CF&I R. 311-12, 341-42), and that if penalty claims or prebankruptcy intercompany claims were allowed to participate with general unsecured claims on a pro-rata basis, distributions to general unsecured creditors would be reduced (CF&I R. 325-26).

The Debtors were deeply insolvent. (Opp. 3a-4a; CF&I R. 208-218). The Section 4971 claims exceeded estimated distributions to all general unsecured creditors. (CF&I R. 206). The Bankruptcy Court found that allowing the IRS the same distributive priority as the PBGC and other general unsecured creditors would advance neither the legislative purpose of Section 4971 nor the principle of equality of distribution that underlies the Bankruptcy Code. *See Begier v. IRS*, 496 U.S. 53, 58 (1990) ("Equality of distribution among creditors is a central policy of the Bankruptcy Code."). Instead it would punish creditors. (Pet. 50a-51a).

The Bankruptcy Court also found that the IRS' claims, if given priority, would have defeated any attempt by the Debtors to reorganize. (Pet. 51a). Among the interests dependent upon a successful reorganization (in this case, through the sale of assets to another steel manufacturer under the Plan) were the jobs of approximately 1,500 employees (CF&I R. 163) and the medical benefits of approximately 5,164 retirees and 3,489 dependents of retirees (CF&I R. 193).

On February 12, 1993, the Bankruptcy Court entered its order confirming the Plan. (Pet. 22a-37a). The Bankruptcy Court made all findings and conclusions required by law for confirmation of the Plan, including that the Plan complied with all applicable provisions of the Bankruptcy Code, and specifically those respecting classification of claims and contents of the Plan (Pet. 27a), that the Plan was proposed in good faith and not by any means forbidden by law (*id.*), and that as to impaired classes of claims that did not accept the Plan (such as Class 13 that included the IRS' penalty claims) the Plan did not discriminate unfairly and was fair and equitable (Pet. 28a). Although the

Bankruptcy Court sustained some of the IRS' objections to the Plan by requiring modifications of the Plan that included extinguishing CF&I's stock in its subsidiaries, the IRS' objections based on the tax priority of its Section 4971 claims were overruled. (Pet. 23a-24a).

The Bankruptcy Court's Ruling on Subordination of the IRS' Claims. By order dated March 10, 1993, the Bankruptcy Court granted the Debtors' summary judgment motion (filed prior to confirmation) to subordinate pursuant to Section 510(c) of the Bankruptcy Code all of the IRS' nonpecuniary loss penalty claims under Section 4971, to the extent not disallowed (*see supra* note 5), to the claims of general unsecured creditors who suffered pecuniary losses. (Pet. 19a-21a). The IRS has not disputed any of the detailed factual findings of the Bankruptcy Court which are set forth in full in the appendix to the Reorganized Debtors' Brief in Opposition to Certiorari (Opp. 1a-6a), including the Court's finding that the Debtors had a multitude of financial problems and did not file bankruptcy solely to deal with the IRS' claims or to avoid payment of tax penalties (Opp. 3a-5a). Consequently, the IRS' claims were subordinated under both the Plan and under Section 510(c).[7]

[7] The Bankruptcy Court ruled on subordination in conjunction with confirmation of the Plan, which is one of the three orders on appeal here. (Opp. 3a). The IRS did not object to the Plan's classification or treatment of nonpecuniary loss penalty claims in Class 13 and has never challenged the Bankruptcy Court's findings that the Plan complied with the Bankruptcy Code's requirements respecting classification and treatment of such claims. (Pet. 27a-28a). The IRS only objected to being included in Class 13 by arguing its claims were taxes, not penalties. Because the IRS did not object to Class 13, the Bankruptcy Court approved the classification without addressing arguments on classification. If the Bankruptcy Court's order regarding priority is upheld, the IRS has not preserved any objection as to its treatment under the Plan.

The IRS sought, but was denied, a stay pending appeal. (Pet. 14a). On November 23, 1993, in a consolidated appeal, the District Court affirmed the Bankruptcy Court's orders on priority, confirmation and subordination. (Pet. 10a-11a). The Court of Appeals for the Tenth Circuit affirmed the District Court's decision. (Pet. 1a-9a). The Court of Appeals concluded that "the bankruptcy court correctly refused to treat the [Internal Revenue Code's] label as determinative for priority in bankruptcy." (Pet. 6a). With regard to subordination of the Section 4971 claims, the Court of Appeals followed the majority of courts in holding that 11 U.S.C. § 510(c) "does not require a finding of claimant misconduct to subordinate nonpecuniary loss tax penalty claims." (Pet. 8a).[8]

In a separate proceeding in these bankruptcy cases, the District Court found that the Plan had been substantially consummated and that challenges to the confirmation order were moot, at least insofar as they seek to upset sales transactions and property transfers that have taken place in reliance on the confirmation order. *United Mine Workers of Am. Combined Fund v. CF&I Fabricators of Utah, Inc. (In re CF&I Fabricators of Utah, Inc.)*, 169 B.R. 984, 993-94 (D. Utah 1994). Even though the IRS has appealed the confirmation order, the IRS would have full relief as to its Section 4971 claim (i.e., priority as an excise tax or a general unsecured claim) if any relief granted by the Court were limited to the matters of priority argued by the IRS. The Plan as confirmed provides for full payment of allowed priority tax claims and provides that if nonpriority penalty claims are not subordinated they will be included with other general unsecured creditors. (CF&I R. 134, 141). The IRS has not argued that the entire Plan should or could be undone.

[8] The IRS substitutes the words "excise tax claim of the United States" in place of "IRS's penalty claim" in its quotation of the Court of Appeals' opinion. (IRS Br. 10; Pet. 8a). This distinction is critical to the Court of Appeals' reasoning.

INTRODUCTION AND SUMMARY OF ARGUMENT

1. In the Bankruptcy and District Courts, the IRS claimed that the Debtors' failure to pay $25.6 million to the Pension Plans rendered their estates liable for $41.8 million in 10% and 100% "excise taxes" under Section 4971. Even though the IRS could offer no evidence of monetary loss, the IRS insisted that its $41.8 million claims be paid on a priority basis that would have eliminated any recovery for the PBGC, the retirees, the Noncontributory Plan, and all other general unsecured creditors, thereby destroying the Debtors' reorganization. Faced with the unsavory prospect of arguing that result to the Court of Appeals, the IRS narrowed its appeal, changing the amount, but not the substance, of its claims.

a. The IRS asserts that its Section 4971 claims are entitled to priority under 11 U.S.C. § 507(a)(7)(E) ("Section 507(a)(7)(E)") as an "excise tax on . . . a transaction occurring before the filing of the petition." The IRS bases its claim to priority on the superficial argument that because Section 4971 uses the word "tax" and appears in the Internal Revenue Code under the subtitle heading "Miscellaneous Excise Taxes," claims under this section must conclusively be considered "excise taxes" under Section 507(a)(7)(E). The Court has held that similar words used in different federal statutes should not be presumed to have the same meanings. Nevertheless, the IRS mistakenly presumes that the words "tax" and "excise tax" must have identical meanings in Section 4971 and Section 507(a)(7)(E) despite the different purposes of these two statutes and Section 4971's admittedly noncompensatory and punitive nature. The language of the Bankruptcy Code and the Court's cases demonstrate that Internal Revenue Code labels do not control priorities in bankruptcy.

b. The IRS' claims do not meet the two statutory prerequisites for priority under Section 507(a)(7)(E) because its claims are neither "taxes" for purposes of the Bankruptcy Code nor did the claims arise from "a transaction occurring" before the Petition Date. Decisions of the Court have given the term "tax" an established meaning under bankruptcy law. There is no evidence that the Bankruptcy Code modified that established meaning. The IRS has acknowledged that if this traditional meaning is applied in this case, its claims are not entitled to tax priority because the purpose of Section 4971 is not to raise revenue for the government but rather to punish pension plan sponsors for a violation of ERISA. "Excise tax" claims similar to the IRS' Section 4971 claims were held not to have tax priority under the Bankruptcy Act and there is no evidence that the Bankruptcy Code elevated nonpecuniary loss penalties to a new priority status. Section 507(a)(7)(G) denies priority to prepetition nonpecuniary loss penalties.

c. The IRS incorrectly asserts, based solely on the phrasing of legislative materials, that Section 507(a)(7)(E) grants "unqualified comprehensive" priority to "any" and "every" excise tax. (IRS Br. 4, 11, 14, 21). The actual language of the statute grants priority to unsecured claims of governmental units "only to the extent that such claims are for . . . an excise tax on (i) a transaction occurring [within the specified period]." 11 U.S.C. § 507(a)(7)(E). The Section 4971 claims are not based on a "transaction" having occurred, but instead are imposed upon the nonoccurrence of a pension funding payment.

2. The Bankruptcy Court properly found that under the "facts presented in this case" the IRS' nonpecuniary loss claims properly should be subordinated to the claims of creditors who suffered pecuniary losses. (Opp. 5a). The Bankruptcy Court did not subordinate the IRS' penalty claims based on vague perceptions of fairness as the IRS suggests (IRS Br. 27) or on "subjective notions," "hostility," or popularity as the PBGC suggests (PBGC Br. 20), but rather subordinated the claims based on detailed factual findings made in the context of a carefully negotiated plan overwhelmingly approved by creditors, including the PBGC.

a. The Plan was required by law to place the Section 4971 claims in a separate, subordinated class. Section 1129(a)(7) of the

Bankruptcy Code required that nonconsenting impaired creditors must receive as much under the Plan as in a Chapter 7 liquidation. Because prepetition nonpecuniary loss penalty claims are expressly subordinated in Chapter 7, Section 1129(a)(7) could only be met by separately classifying the Section 4971 claims under 11 U.S.C. § 1122 and subordinating that class to general unsecured claims under the Plan. Unlike priority claims, no "distributive category" (IRS Br. 12) exists for general unsecured claims under the Bankruptcy Code.

b. The lower courts correctly held that Section 510(c) of the Bankruptcy Code does not require a finding of inequitable conduct, either in its language, its history or its purpose. Subordinating nonpecuniary loss tax penalties under "principles of equitable subordination" is consistent with the Court's decisions regarding the purpose of equitable subordination and with all of the decisions of Courts of Appeals which have addressed this issue. The Bankruptcy Court's findings that the IRS' claims would punish and be paid principally by the very creditors (the PBGC and retirees) intended to be protected by pension funding requirements fully supported subordination of these claims.

ARGUMENT

I. SECTION 4971 CLAIMS ARE NOT ENTITLED TO PRIORITY AS "EXCISE TAXES" ON "TRANSACTIONS."

A. The Bankruptcy Code Does Not Define "Excise Tax" by Reference to the Internal Revenue Code.

The IRS' purported "plain meaning" argument is not founded on the plain language of the Bankruptcy Code. Instead, the IRS uses nonbankruptcy statutes and legislative materials to interpret Section 507(a)(7)(E). The IRS cites no authority for its basic assumption that the words "tax" and "excise tax" in the Internal Revenue Code must have the identical meanings as the words "tax" and "excise tax" in Section 507(a)(7)(E). The IRS errs in first assuming that "excise tax" will have an identical meaning in

both statutes and, based on that faulty assumption, in concluding that the language "is plain" and that its claim falls "literally and precisely" within Section 507(a)(7)(E).

When definitions from the Internal Revenue Code are to apply in bankruptcy, the Bankruptcy Code specifically cites to such statutes. *See, e.g.*, 11 U.S.C. § 101(41)(C)(i) ("governmental plan, as defined in section 414(d) of the Internal Revenue Code"); 11 U.S.C. § 101(41)(C)(ii) ("eligible deferred compensation plan, as defined in section 457(b) of the Internal Revenue Code"); 11 U.S.C. § 346(g)(1)(c) (gains or losses on transfers of estate property in Chapter 11 cases to a debtor's affiliates are recognized "to the same extent that such transfer results in the recognition of gain or loss under section 371 of the Internal Revenue Code").[9] Similarly, where the Bankruptcy Code grants priority to a class of claims arising under another federal statute, it also does so expressly. *See, e.g.*, 11 U.S.C. § 503(b)(6) (administrative

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[9] Additional examples in the Bankruptcy Code of an express application of definitions, terms or provisions from other federal statutes include: § 101(21B)(A) ("insured depository institution"); § 101(33)(B) ("institution-affiliated party"); § 101(39) ("mask work"); § 101(48) ("exempted securities"); § 109(b) ("insured bank"); § 345(b)(2) ("securities"); § 362(b)(12) (an action under the Ship Mortgage Act); § 362(b)(16) ("guaranty agency"); § 363(b) (the Clayton Act); § 365(d)(6)(C) ("aircraft"); § 522(d)(10)(E)(iii) (the Internal Revenue Code); § 523(a)(13) (title 18, United States Code); § 523(a)(2)(C) ("an extension of consumer credit"); § 525(a) (Perishable Agricultural Commodities Act and the Packers and Stockyards Act); § 525(c)(2) ("student loan program"); § 541(b)(3) (Higher Education Act of 1965); § 555 (Securities Investor Protection Act of 1970); § 724(d) (Internal Revenue Code); § 761(5), (6), (7), (8) ("commodity option," "contract market," "contract of sale," "commodity," "future delivery," "board of trade," and "futures commission merchant"); § 1110(a)(2)(A) ("aircraft"); § 1110(a)(2)(B) ("documented vessel"); § 1145(b) ("underwriter"); § 1166 (Regional Rail Reorganizational Act of 1973); and § 1167 (Railway Labor Act).

expense priority includes "the fees and mileage payable under chapter 119 of title 28"); 11 U.S.C. § 507(a)(1) (first priority granted to "any fees and charges assessed against the estate under chapter 123 of title 28").

The IRS concedes that labels do not control state claims (IRS Br. 19-20 n.11) but insists on a different rule for federal claims. Where Congress wanted to make such a distinction, it did so clearly and unequivocally, as in Section 346(a) of the Bankruptcy Code, which provides:

> Except to the extent otherwise provided in this section, subsections (b), (c), (d), (e), (g), (h), (i), and (j) of this section apply *notwithstanding any State or local law imposing a tax, but subject to the Internal Revenue Code of 1986.*

11 U.S.C. § 346(a) (emphasis added).

If Congress had intended Internal Revenue Code meanings to control tax priorities under Section 507(a)(7)(E) or to grant wholesale "excise tax" priority to all claims assessed against a debtor under Subtitle D of Title 26, an express reference would have been made. Instead, Congress chose not to define the terms "tax" and "penalty" in the Bankruptcy Code, either directly or by reference to another statute. Consequently, these terms should be given their commonly understood meanings for bankruptcy purposes. *Field v. Mans*, 116 S. Ct. 437, 443 (1995) ("'[U]nless the statute otherwise dictates, . . . Congress means to incorporate the established meaning of these terms.'") (*quoting NLRB v. Amax Coal Co.*, 453 U.S. 322, 329 (1981)).

B. The Section 4971 Claims Are Not Taxes for Purposes of the Bankruptcy Code.

The Bankruptcy Act of 1898, 11 U.S.C. §§ 1-1103 (repealed 1978), granted priority to "taxes" but did not define this term. Consequently, the courts developed a definition of "taxes" in bankruptcy that has been applied for nearly a century, with remarkably little change over that period. In 1906, the Court

reviewed a state corporation franchise tax to determine its tax priority under Section 64a of the Bankruptcy Act (11 U.S.C. § 104a (repealed 1978)). *New Jersey v. Anderson*, 203 U.S. 483, 492 (1906). The Court stated, "Generally speaking, a tax is a pecuniary burden laid upon individuals or property for the purpose of supporting the government." *Id.* The Court held that the state's claim had all of the characteristics of a tax and was entitled to tax priority. *Id.*

The Court has since applied a similar analysis to both state and federal exactions. *See United States v. Childs*, 266 U.S. 304, 309-10 (1924) ("interest" on federal taxes distinguished from a "penalty"); *New York v. Jersawit*, 263 U.S. 493, 496 (1924) (statutory "interest" on a state claim treated as a "penalty" for bankruptcy purposes). In *City of New York v. Feiring*, 313 U.S. 283 (1941), the Court restated the principle that true "taxes" for purposes of bankruptcy law are defined as "pecuniary burdens laid upon individuals or their property, regardless of their consent, for the purpose of defraying the expenses of government or of undertakings authorized by it." *Id.* at 285, 287 (*citing New Jersey v. Anderson*, *supra*, and *United States v. Updike*, 281 U.S. 489, 494 (1930) (a federal claim under the Internal Revenue Act of 1926 was a "tax")). The *Feiring* Court ruled that a New York City sales tax met this definition and consequently was entitled to tax priority under the Bankruptcy Act. *Id.* at 288.

The *Feiring* definition of a "tax" was developed by the Court precisely for differentiating between true taxes and other types of federal and state claims (however denominated) for purposes of bankruptcy priority. However, this definition was simply a summary of the already well established understanding of a "tax" for various purposes. Therefore, the IRS' attempt to distinguish *Feiring* as involving a state, as opposed to a federal, statute misses the point. Similar reasoning had long been applied to federal statutes. The *Feiring* decision simply became a commonly cited definition in an extensive line of cases regarding both state and federal claims in bankruptcy. *See Texas Am. Oil Corp. v. United*

States Dep't of Energy, 44 F.3d 1557, 1571 (Fed. Cir. 1995) (*en banc*) ("restitution" in Petroleum Overcharge and Distribution Act was partially a penalty for bankruptcy purposes); *United States v. River Coal Co.*, 748 F.2d 1103, 1106 (6th Cir. 1984) (a federal "reclamation fee" was a tax for bankruptcy purposes). Even the PBGC agrees that the *Feiring* rationale applies to at least some federal statutory claims, as it must in order to argue that unfunded pension benefit liabilities under ERISA are "taxes" for bankruptcy purposes. (PBGC Br. 18-19).

After the *Feiring* decision, the Court, in analyzing a *federal* excise tax for bankruptcy purposes, held, "We think that our decision in the *Feiring* case is controlling here." *United States v. New York*, 315 U.S. 510, 515 (1942). In *New York*, the Court examined whether an amount labeled as a "tax" under the Social Security Act was a "tax" for purposes of bankruptcy. *Id.* at 513-16.[10] Applying the *Feiring* definition of a tax, the Court concluded, "The New York City sales tax involved in that case [*Feiring*] and the obligation imposed by . . . the Social Security Act cannot be distinguished in any material respect." *Id.* at 515. The Court further held that, under the *Feiring* definition, the federal claim was a true tax for priority in bankruptcy because it was compensatory to the government. *Id.* at 517. The Court stated, "[A] tax for purposes of § 64, sub. a (4) [of the Bankruptcy Act] includes any 'pecuniary burden laid upon individuals or property for the purpose of supporting the government,' *by whatever name it may be called*." *Id.* at 515-16

[10] The PBGC brushes aside *New York* by arguing that "the statutory language [was] ambiguous." (PBGC Br. 19). But in *New York*, the Internal Revenue Code clearly identified the amount as a tax. 315 U.S. at 512 n.2. The Court specifically referred to it as a tax for purposes of that statute, but nevertheless examined the substance of the claim for bankruptcy purposes.

(*quoting New Jersey v. Anderson*, 203 U.S. 483, 492 (1906)) (emphasis added).[11]

By contrast, under bankruptcy law, a "penalty" is not enacted for the purpose of supporting the government. *See United States v. Unsecured Creditors Comm. of C-T of Va., Inc. (In re C-T of Va., Inc.)*, 977 F.2d 137, 139 (4th Cir. 1992), *cert. denied*, 113 S. Ct. 1644 (1993) (court determined that an "excise tax" under 26 U.S.C. § 4980 was not a "penalty" but rather a revenue raising statute); *see also In re Caponigri*, 193 F. 291, 292 (S.D.N.Y. 1912) ("[I]n substance, an obligation is penal when its amount is measured neither by the obligee's loss nor by the valuation placed

[11] The IRS does not argue that the *Feiring/New York* definition of a tax is incorrect. The IRS has used a nearly identical definition in its revenue rulings concerning the deductibility of taxes:

> A tax is an enforced contribution, exacted pursuant to legislative authority in the exercise of taxing power, and imposed and collected for the purpose of raising revenue to be used for public or governmental purposes . . . . [T]he question whether a particular contribution or charge is to be regarded as a tax depends upon its real nature. If it is in the nature of a tax, it is not material that it may be called by a different name; and, conversely, if it is not in the nature of a tax, it is not material that it may be so called.
>
> A charge primarily imposed for the purpose of regulation is not a tax, even though it produces revenue.

Rev. Rul. 57-345, 1957-2 C.B. 132, 133, *revoked as to the result by* Rev. Rul. 60-366, 1960-2 C.B. 63, 65; *see Campbell v. Davenport*, 362 F.2d 624, 628 (5th Cir. 1966) (the definition in Rev. Rul. 60-366 is "basically the same definition" as in Rev. Rul. 57-345). In Revenue Ruling 60-366, the IRS noted, "The word 'taxes' as used in [26 U.S.C. § 164] is nowhere defined in the [Internal Revenue] Code, and, it must be 'given its ordinary and commonly accepted meaning as established by the judicial decisions.'" Rev. Rul. 60-366, 1960-2 C.B. at 64 (*quoting United Gas Improvement Co. v. Commissioner*, 25 B.T.A. 1382, 1384 (1932)).

by him upon what he has given in exchange."). The Court has stated that federal claims are penalties, regardless of their label, where they are "imposed at least in part as punitive measures against persons who have been guilty of some default or wrong." *Simonson v. Granquist*, 369 U.S. 38, 40-42 (1962) ("[T]he character of a [federal tax] penalty is by no means changed by calling it a lien.").[12]

Amounts under Section 4971 do not meet the Court's test for a "tax" in bankruptcy. Section 4971 was enacted solely to coerce obedience to statutory pension funding requirements, not to raise revenue to support the government. Section 4971 would fulfill its purpose of enforcing compliance with pension funding laws if no 10% or 100% amounts were ever incurred. The legislative history of ERISA states, "Since the employer remains liable for the contributions necessary to meet the funding standards even after the payment of the excise taxes, it is anticipated that few, if any, employers will willfully violate these standards." H.R. Rep. No. 807, 93rd Cong., 2d Sess. 28 (1974). A detailed itemization of revenues and costs for ERISA in the legislative history reveals that no revenues were projected from Section 4971. *See* S. Rep. No. 383, 93d Cong., 1st Sess. 35-38, 71, 148-49 (1973).[13]

[12] Several other pre-*Feiring* cases illustrate the distinction between taxes and penalties. In addressing constitutional issues not relevant here, the Court expressed the view that a critical difference between a tax and a penalty is that a penalty is imposed for the violation of another statute. *United States v. Constantine*, 296 U.S. 287, 295 (1935); *United States v. La Franca*, 282 U.S. 568, 572 (1931); *Bailey v. Drexel Furniture Co.*, 259 U.S. 20, 38 (1922). A similar distinction assists in understanding the meanings of "tax" and "penalty" in the context of priority in bankruptcy. Claims under Section 4971 are imposed only upon violation of a statutory obligation to fund a pension plan.

[13] The fact that the IRS requires Section 4971 amounts to be reported on a return or that the IRS otherwise treats Section 4971 as a tax in nonbankruptcy situations is not controlling. Furthermore, the (continued...)

Unlike the federal claims in *United States v. New York*, *supra*, the underlying punitive purpose of Section 4971 is undisputed. (Pet. 47a-49a). Section 4971's legislative history states:

> The bill [ERISA] also provides new and more effective *penalties* where employers fail to meet the funding standards. In the past, an attempt has been made to enforce the relatively weak funding standards existing under present law by providing for immediate vesting of the employees' rights, to the extent funded, under plans which do not meet these standards. This procedure, however, has proved to be defective since it does not directly *penalize* those responsible for the underfunding. For this reason, the bill places the obligation for funding and the *penalty for underfunding on the person on whom it belongs--namely, the employer.*

H.R. Rep. No. 807, 93rd Cong., 2d Sess. 28 (1974) (emphasis added). The IRS acknowledged in the lower courts that if the Internal Revenue Code label for its claims does not control, "it would not be able to sustain the position that the section 4971 excise taxes are not penalties." (Pet. 48a-49a).

Not long after Congress enacted ERISA, two Courts of Appeals denied tax priority under the Bankruptcy Act to an exaction under Subtitle D, Miscellaneous Excise Taxes, that was

[13](...continued)
lower courts are not unanimous in their treatment of "penalty excise taxes" even for tax purposes. *Latterman v. United States*, 872 F.2d 564, 570 (3d Cir. 1989) (in holding that 26 U.S.C. § 4975(a) should be treated as a tax for purpose of the Internal Revenue Code, the court expressly stated that bankruptcy considerations were not relevant in that case); *Rockefeller v. United States*, 572 F. Supp. 9, 16 (E.D. Ark. 1982), *aff'd*, 718 F.2d 290 (8th Cir. 1983) ("excise taxes" under 26 U.S.C. § 4941 treated as penalties for tax purposes).

very similar to Section 4971.[14] In both cases, the Courts of Appeals held that the statute was intended to punish the debtor rather than to raise revenue under the *Feiring* definition. *Mahon v. United States (In re Unified Control Sys., Inc.)*, 586 F.2d 1036, 1037-39 (5th Cir. 1978) ("excise tax" imposed under 26 U.S.C. § 4941 was a penalty and not an excise tax for bankruptcy purposes); *United States v. Feinblatt (In re Kline)*, 403 F. Supp. 974, 978 (D. Md. 1975), *aff'd*, 547 F.2d 823 (4th Cir. 1977) ("excise taxes" under 26 U.S.C. § 4941 treated as penalties). The reasoning in these cases applies equally to Section 4971. Therefore, under the long-standing application of the Court's decisions, Section 4971 is a not a tax for purposes of bankruptcy priority.

C. Internal Revenue Code Labels Are Not Conclusive for Purposes of the Bankruptcy Code.

The reasoning of *City of New York v. Feiring* and *United States v. New York*, and their progeny in the lower courts, is firmly grounded in recognized principles of statutory construction. The Court has often recognized that the meaning of words or phrases in one federal statute is not conclusive when applied to another statute: "It is not unusual for the same word to be used with different meanings in the same acts, and there is no rule of statutory construction which precludes the courts from giving to the word the meaning which the Legislature intended it should have in each instance." *Atlantic Cleaners & Dyers, Inc. v. United States*, 286 U.S. 427, 433 (1932) (citations omitted); *see Fogerty v. Fantasy, Inc.*, 114 S. Ct. 1023, 1027-28 (1994) (the meaning of the attorney's fees statute in the Civil Rights Act is different

[14] Section 4971 was modeled after the private foundation "excise tax" penalties enacted in 1969, such as 26 U.S.C. § 4941. *See* S. Rep. No. 383, 93d Cong., 1st Sess. 70-71 (1973) ("In accord with present law respecting the excise taxes with regard to private foundations, neither the 5 percent nor the 100 percent taxes [under Section 4971] are to be deductible.").

from a "virtually identical" provision of the Copyright Act); *Director, Office of Workers' Compensation Programs v. Perini N. River Assocs.*, 459 U.S. 297, 320 n.29 (1983) (the term "maritime" has different meanings in 28 U.S.C. § 1333(1) and in § 2(3) of the Longshoremen's and Harbor Workers' Compensation Act); *Massachusetts v. United States*, 435 U.S. 444, 460 n.18 (1978) ("That [26 U.S.C.] § 4491 is called or can be characterized as a 'tax' thus possesses no talismanic significance" for a different purpose); *South Chicago Coal & Dock Co. v. Bassett*, 309 U.S. 251, 259-60 (1940) ("We find little aid in considering the use of the term 'crew' in other statutes having other purposes."); *Price v. United States*, 269 U.S. 492, 500 (1926) ("The meaning properly to be attributed to that word [debt] depends upon the connection in which it is used in the particular statute and the purpose to be accomplished."). Even within the Internal Revenue Code, the Court has stated that the federal tax provisions need not be read *in pari materia*. "In interpreting the particular income tax provisions here involved, we find ourselves unfettered by the language and considerations ingrained in the gift and estate tax statutes." *United States v. Davis*, 370 U.S. 65, 69 n.6 (1962) (citation omitted).

Thus, the IRS errs in asserting that an Internal Revenue Code "tax" label precludes any inquiry into whether such label is consistent with the purposes of the Bankruptcy Code. In *Helwig v. United States*, 188 U.S. 605 (1903), the Court addressed whether an "additional duty" under the federal Customs Administration Act of 1890 was a "penalty" for purposes of determining jurisdiction of the district courts. *Id.* at 610. The Treasury Secretary argued that because the Act labeled the amount an "additional duty," it could not be considered a "penalty." The Court disagreed, stating that for purposes of the jurisdictional statute at issue:

> [I]t is clear that the sum is not imposed for any purpose of revenue, but is in addition to the duties imposed upon the particular article imported, and in each individual case when

the sum is imposed it is based upon the particular act of the importer. That particular act is his undervaluation of the goods imported, and is without doubt a punishment upon the importer on account of it. Whether the statute defines it in terms as a punishment or penalty is not important, if the nature of the provision itself be of that character.

. . .

[W]hether called a "further sum" or an "additional duty," or by some other name, the amount imposed was so large in proportion to the value of the merchandise imported, as to show beyond doubt that it was a sum imposed not, in fact, as a duty upon an imported article, but as a penalty, and nothing else.

Id. at 611. The Court concluded that, although Congress could have directed that the "additional duty" not be treated as a penalty for jurisdictional purposes, in the absence of such direction, the Court would look to the substance of the assessment. *Id.* at 613.

Therefore, when construing language from two separate federal statutes, it is necessary to examine the purposes for which they were enacted. As Justice Cardozo observed, "Our concern is to define the meaning [of a term] for the purpose of a particular statute which must be read in the light of the mischief to be corrected and the end to be attained." *Warner v. Goltra*, 293 U.S. 155, 158 (1934); *see Claridge Apartments Co. v. Commissioner*, 323 U.S. 141, 146, 160 (1944) (legislation should be construed in accordance with the problem to be addressed).

Ignoring these rules of statutory construction, the IRS criticizes the lower courts for looking at the purposes of Section 507(a)(7)(E) and Section 4971 and for subjecting claims under Section 4971 to the traditional test for tax priority in bankruptcy. (IRS Br. 9, 19). Under the IRS' argument *every* substantive term used in the Internal Revenue Code must have the identical meaning when used in the Bankruptcy Code, as well as in every other federal statute. This argument would impose an unreasonable

burden upon Congress to ensure all terms have precisely uniform meanings throughout the entire United States Code. It is unlikely that the IRS would agree to the use of labels in the Bankruptcy Code to decide issues arising under the Internal Revenue Code. *See Commissioner v. Lincoln Sav. and Loan Ass'n*, 403 U.S. 345, 359 (1971) (finding that "the statutory labels of 'prepayment' and 'additional premium' contained in § 404(d) [of the National Housing Act] are not controlling" for tax purposes).[15]

The Bankruptcy Code governs priorities for claims in bankruptcy cases and courts applying it cannot, in the absence of clear statutory direction, be bound by other statutes serving other purposes. Because priority claims dilute or eliminate payments to general unsecured creditors, the Court has held that "'if one claimant is to be preferred over others, the purpose should be clear from the statute.'" *United States v. Embassy Restaurant, Inc.*, 359 U.S. 29, 31 (1959) (*quoting Nathanson v. NLRB*, 344 U.S. 25, 29 (1952)). In *Embassy Restaurant*, the Court held that claims for contributions by an employer to a union welfare fund were not entitled to priority in bankruptcy as "wages," even

[15] Federal courts and the IRS have addressed issues similar to this case for decades under 26 U.S.C. § 162 which permits the deduction of certain state and federal taxes but not penalties. Neither the courts nor the IRS have felt constrained by the labels used by other federal statutes. In one revenue ruling, the IRS held that a "nonconformance penalty" under the Clean Air Act is not a "penalty" for purposes of Section 162, reasoning, "The legislative history of the NCP shows that it is not punitive in nature. . . . Mere nonconformity within the allowable range of nonconformity *is not a violation of the Act* if there is a payment of the NCP." Rev. Rul. 88-46, 1988-1 C.B. 76, 77 (emphasis added); *see also Colt Industries, Inc. v. United States*, 880 F.2d 1311, 1314 (Fed. Cir. 1989) ("penalties" under Clean Air Act and Clean Water Act are true penalties for § 162 purposes); *Talley Indus. v. Commissioner*, 68 T.C.M. (CCH) 1412, 1418 (1994) (whether a "penalty" under the False Claims Act is a penalty for purposes of § 162 depends upon its compensatory nature).

though such benefits may be considered "wages" under the National Labor Relations Act and the Social Security Act. The Court stated, "We construe the priority section of the Bankruptcy Act, not those statutes." 359 U.S. at 33.

In *Embassy Restaurant*, the Court first noted that the contributions could not be treated as wages "unless it is clear that [the contributions] satisfy the purpose for which Congress established the priority." *Id.* at 34. Furthermore, the Court found it significant that "if the claims of the [welfare plan] are to be treated on a par with wages, in a case where the employer's assets are insufficient to pay all in the second priority, the workman will have to share with the welfare plan, thus reducing his own recovery." *Id.* at 33-34.

The Court has previously rejected arguments that a label in the Internal Revenue Code is determinative of treatment in bankruptcy. In *Simonson v. Granquist*, 369 U.S. 38 (1962), the IRS filed a claim for a tax penalty secured by a valid statutory lien under Section 6321 of the Internal Revenue Code. The IRS argued that its claim was entitled to priority as a secured claim and that the Bankruptcy Court lacked power to avoid a lien valid under the Internal Revenue Code. Brief for the Respondents at 8, *Simonson v. Granquist* (No. 83). The Court held that although the penalty was denominated a "lien" by the Internal Revenue Code, Section 57j of the Bankruptcy Act disallowed all penalties. *See* 11 U.S.C. § 93j (repealed 1978). Noting the different purposes of the two statutes, the Court ruled that the Internal Revenue Code's label did not control and that "the character of a penalty is by no means changed by calling it a lien." 369 U.S. at 42; *see United States v. Sotelo*, 436 U.S. 268, 275 (1978) (an IRS claim under 26 U.S.C. § 6672, although labeled a "penalty," was in essence a tax

for purposes of dischargeability under Section 17(a) of the Bankruptcy Act).[16]

Comparing the purposes of Sections 4971 and 507(a)(7)(E) is both relevant and necessary. The purpose of Section 507(a)(7)(E) is to ensure that the government receives revenues necessary to operate. *See Price v. United States*, 269 U.S. 492, 499-500 (1926) ("[P]riority statutes were enacted to . . . secure adequate public revenue to sustain the public burdens."). Section 4971 has no revenue raising function. Its sole purpose is to protect retirees' pensions and punish plan sponsors who underfund pensions. *See supra* at 20-21. If the IRS' claims had been given priority in the amounts asserted initially, they would have diluted legitimate state and local tax claims and, by defeating the reorganization, would have jeopardized the full funding of the Noncontributory Plan and the recovery of the PBGC, a portion of which would go to the Debtors' retirees for pension benefits not guaranteed by the PBGC. 29 U.S.C. § 1322(c). The single 10% claim on appeal here will, if paid, be paid out of funds that otherwise would be paid to general unsecured creditors, including the PBGC and, through the PBGC, to retirees. The IRS in effect argues that where an insolvent employer is liquidated, Congress intended to

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[16] Since *Sotelo* was decided, the IRS has successfully argued on several occasions that, *for purpose of the Internal Revenue Code*, Section 6672 is a *penalty* and not a tax. Most recently, in *Duncan v. Commissioner*, the Tax Court ruled in favor of the IRS on this issue, stating:

> In [*Sotelo*], the Supreme Court held that sec. 6672 constitutes a "tax," rather than a "penalty," for purposes of dischargeability under the Bankruptcy Act. We stated in *Patton v. Commissioner* [Dec. 35,589], 71 T.C. 389, 390-391 (1978), that the Supreme Court's decision had "no controlling effect upon the meaning of 'penalty' in section 162(f) [of the Internal Revenue Code], which is directed to an entirely different problem."

66 T.C.M. (CCH) 420, 423 n.9 (1993) (citations omitted).

fund the IRS' Section 4971 claims at the direct expense of retirees and other unsecured creditors, not simply once, but in compounding amounts. The IRS' position also forces the incongruous conclusion that Congress intended to grant priority status to alleged "tax" claims based on pension funding deficiencies, when the underlying pension contributions themselves were not given priority. *See Otte v. United States*, 419 U.S. 43, 57 (1974) ("[I]t is anomalous to accord withholding taxes a higher priority than the wage claims to which they so directly relate.").[17]

This absurd result is a strong reason not to interpret these two federal statutes to defeat the purposes of both. Faced with a similar conflict between the IRS' interpretation of a bankruptcy statute and its evident purpose, the Court stated, "To this [result] the Government might be entitled if the statutory mandate were clear. It cannot have that advantage by dubious construction which ignores so much of the statute's setting, purpose and history. The letter does not require this. The consequences forbid it." *Claridge Apartments Co. v. Commissioner*, 323 U.S. 141, 164-65 (1944). If the Court does as the IRS urges in this case and punishes the retirees/plan participants for the Debtors' prepetition failure to meet the minimum funding standards, this truly will be a case where "[t]he cure [is] worse than the disease." *Id.* at 151.

D. The Enactment of the Bankruptcy Code Did Not Alter the Established Meaning of "Tax" for Bankruptcy Purposes.

When the Bankruptcy Code was adopted in 1978, the meaning of "tax" for purposes of bankruptcy priority were correctly governed by the Court's cases, not by labels in nonbankruptcy federal and state statutes. The *Feiring* definition was so well

[17] If the PBGC's claims were entitled to priority, as it asserts, any Section 4971 amounts would be duplicative and an unnecessary enforcement mechanism.

entrenched that Black's Law Dictionary similarly defined a tax as "[a] pecuniary burden laid upon individuals or property to support the government, and is a payment exacted by legislative authority." BLACK'S LAW DICTIONARY 1628 (4th ed. 1968) (citations omitted). A penalty, on the other hand was defined as "a punishment imposed by statute as a consequence of the commission of an offense." *Id.* at 1290 (citations omitted).

If, in enacting the Bankruptcy Code, Congress had intended to elevate formerly disallowed nonpecuniary loss claims to priority status or to modify the well established definition of "tax" for purposes of priority in bankruptcy, one would expect Congress to make a clear statement to that effect. The Court has stated that it is "reluctant to accept arguments that would interpret the [Bankruptcy] Code . . . to effect a major change in pre-Code practice that is not the subject of at least some discussion in the legislative history." *Dewsnup v. Timm*, 502 U.S. 410, 419 (1992) (citations omitted); *see Kelly v. Robinson*, 479 U.S. 36, 53 (1986) (Court noted "the uniform construction of the old [Bankruptcy] Act over three-quarters of a century, and the absence of any significant evidence that Congress intended to change the law in this area . . . ."); *see also Commissioner v. Keystone Consolidated Indus.*, 113 S. Ct. 2006, 2011 (1993) (phrase in the Internal Revenue Code "had acquired a settled judicial and administrative interpretation over the course of a half century before Congress enacted . . . § 4975").[18] Yet the Bankruptcy Code's legislative history has no references to granting priority status to penalty

[18] The IRS gives no explanation why the Bankruptcy Code should be read to change existing law. The PBGC correctly acknowledges that, with respect to tax priorities, Congress intended to maintain the law "as it stood before 1978." (PBGC Br. 12); *see* H.R. Rep. No. 595, 95th Cong., 1st Sess. 190 (1977) ("the kinds of taxes entitled to priority under H.R. 8200 closely follows the categories granted under the Bankruptcy Act"). The IRS' rationale assumes that Congress intended to modify existing law as to federal claims but not state and local claims.

excise taxes of the type denied priority under the Bankruptcy Act in *Mahon v. United States (In re Unified Control Sys., Inc.)*, 586 F.2d 1036, 1037-39 (5th Cir. 1978) and *United States v. Feinblatt (In re Kline)*, 403 F. Supp. 974, 978 (D. Md. 1975), *aff'd*, 547 F.2d 823 (4th Cir. 1977). On the contrary, the legislative history discusses only traditional, transaction-based excise taxes "including sales taxes, estate and gift taxes, gasoline and special fuels taxes, and wagering and truck taxes." 124 Cong. Rec. 32,416 (1978) (statement of Rep. Edwards); *id.* at 34,016 (statement of Sen. DeConcini).[19]

If any Congressional intent is to be inferred from the legislative history of the Bankruptcy Code, it should be that Congress intended to permit courts to continue to apply the accepted and well developed standards that looked beyond statutory labels:

> Thus, any tax liability which *under the Internal Revenue Code or State or local tax law* is payable as a "penalty," in addition to the liability of a responsible person under section 6672 of the Internal Revenue Code, will be entitled to the priority which the liability would receive if it were expressly labeled as a "tax" under the applicable tax law. However, a tax

[19] The IRS resorts often to the wording of the legislative history that "All Federal, State or local taxes generally considered or expressly treated as excises are covered by this category . . . ." (IRS Br. 15, 17, 18, 20). Aside from the fact that the statute does not use these broad terms, this language does not support the IRS' argument. According to this statement, the claim must be a *tax* before determining whether it is "generally considered" or "expressly treated" as an *excise*. Moreover, the IRS agrees that courts are not required to give priority to claims of state governments even though such claims are "expressly treated" as excise taxes under state law. (IRS Br. 19-20 n.11). Therefore, this legislative statement cannot be interpreted to mean that labels are controlling, since it refers to both federal and state taxes.

> penalty which is punitive in nature is given subordinated treatment under section 726(a)(4).

124 Cong. Rec. 32,416 (1978) (statement of Rep. Edwards) (emphasis added); *id.* at 34,016 (statement of Sen. DeConcini).[20]

Congress' purpose in creating a "new, express specification" for excise taxes (IRS Br. 14) was not, as the IRS asserts, to expand the types of claims entitled to tax priority, but rather to avoid the problematic concept of "legally due and owing" under Section 64a of the Bankruptcy Act and to provide specific rules for each type of tax. *See* REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 137 Part I, 93d Cong., 1st Sess. 215 (1973) ("The Commission recommends . . . that the rules to determine the tax priority be stated rather than left to a phrase, e.g., 'legally due and owing.'"); *Green v. Beaman (In Re Beaman)*, 9 B.R. 539, 541 (Bankr. D. Or. 1980) ("Congress sought to enumerate types of taxes for the purpose of setting a time under which each tax would become stale and dischargeable.").

E. The IRS Misinterprets the Plain Meaning of Section 507(a)(7)(G) of the Bankruptcy Code.

The IRS relies on a "negative pregnant" argument that because the text of 11 U.S.C. § 507(a)(7)(G) grants priority for penalties that are "in compensation for actual pecuniary loss," no pecuniary loss test was intended for excise taxes under Section 507(a)(7)(E). (IRS Br. 17-18). However, this conclusion presupposes the correctness of the IRS' argument that "excise

[20] The Senate Finance Committee similarly stated that Section 507(a)(7) grants tax priority to "[a]ny fine or penalty, *however denominated*, in addition to the so-called responsible officer 'penalty,' *which actually represents collection of a tax*. (Under the bankruptcy law, such penalties are 'pecuniary loss' penalties.) *Penalties which are punitive in nature are not to receive this priority*." S. Rep. No. 1106, 95th Cong., 2d Sess. 17 (1978) (emphasis added).

taxes" entitled to priority in bankruptcy would ordinarily include nonpecuniary loss claims in the first place. Under traditional tests for claims asserting tax priority in bankruptcy, the term "tax" by definition already incorporates the concept of pecuniary loss. The negative pregnant argument "is weakest when it suggests results strangely at odds with other textual pointers, like the common-law language at work in the statute here." *Field v. Mans*, 116 S. Ct. 437, 446 (1995). In this case, both traditional tests for tax priority and textual pointers contradict the IRS' argument.

Similarly, the IRS argues that if priority excise taxes are required to be pecuniary loss claims, "Congress would not have found it necessary" to provide a separate categories for excise taxes and pecuniary loss penalties. (IRS Br. 18 n.10). This reasoning is flawed in that, despite the IRS' concerns, the Reorganized Debtors have not argued that every excise tax in the Internal Revenue Code should be treated as a penalty under the Bankruptcy Code. In this case, however, the IRS *agreed* that if traditional tests for tax priority in bankruptcy were applied to its Section 4971 claims, "it would not be able to sustain the position that the section 4971 excise taxes are not penalties." (Pet. 48a-49a). The IRS acknowledged "that legislative intent [of Section 4971] indicates the taxes imposed are penalties" for violation of another federal statute. (Pet. 47a). The IRS failed to produce any evidence of pecuniary loss and admitted it had none. (CF&I R. 56). The very structure of Section 4971(b), assessing cumulative annual penalties of 100%, 200%, etc., demonstrates the absurdity of treating these claims as priority taxes in bankruptcy.

The straightforward meaning of Section 507(a)(7)(G) is that specified pecuniary loss tax penalties have tax priority but that nonpecuniary loss tax penalties do not have tax priority. Even though the Bankruptcy Code no longer automatically disallows governmental penalty claims, *see* 11 U.S.C. § 93j (repealed 1978), the Bankruptcy Code continues the disfavored treatment of prepetition nonpecuniary loss penalties. Therefore, the distinction between taxes and penalties maintained in Bankruptcy Act case law

is still relevant. Section 507(a)(7) distinguishes "taxes" from "penalties" by granting priority to five specified kinds of "taxes," certain specified customs duties, and to "a penalty related to" one of the priority tax or customs duty claims, but only if the penalty is "in compensation for actual pecuniary loss." 11 U.S.C. § 507(a)(7)(G). Pecuniary loss tax penalties were given priority under Section 507(a)(7)(G) because Congress considered them to be a tax in the form of a penalty. *See* 124 Cong. Rec. 32,416 (1978) (statement of Rep. Edwards); *id.* at 34,016 (statement of Sen. DeConcini) ("[A]ny tax liability which, under otherwise applicable tax law, is collectible in the form of a 'penalty,' is to be treated in the same manner as a tax liability."). Nothing in Section 507 indicates that Congress intended to grant similar priority to nonpecuniary loss penalties in the form of a tax.

Section 507(a)(7)(G), like Section 507(a)(7)(E), is preceded by the words "only to the extent that such claims are for." In *United Sav. Ass'n v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365 (1988), the Court found that similar terminology in Section 506(b) of the Bankruptcy Code which grants postpetition interest on oversecured claims had the "substantive effect of denying undersecured creditors postpetition interest." *Id.* at 372. Likewise, this phrase in Section 507(a)(7)(G) has the substantive effect of denying tax priority to prepetition nonpecuniary loss penalty claims.

F. The Section 4971 Claims Are Not Imposed on a "Transaction Occurring" as Required by Section 507(a)(7)(E) of the Bankruptcy Code.

Even if the Section 4971 claims were required to be treated as excise taxes, they are not based on a "transaction occurring" as required by Section 507(a)(7)(E) and, therefore, do not fall "literally, and precisely" within the language of that section. (IRS Br. 11). Instead, these claims arise solely because of the nonoccurrence of pension plan contributions. *See Templar v. Shamokin Area Sch. Dist. (In re Templar)*, 170 B.R. 562, 564 (Bankr. M.D. Pa. 1994) ("occupation tax" is an "excise tax" but

is not based on a transaction and is not entitled to § 507(a)(7)(E) priority). The nonpayment of an obligation is not within the ordinary meaning of the term "transaction." A transaction is defined as an

> [a]ct of transacting or conducting any business; negotiation; management; proceeding; that which is done; an affair. Something which has taken place, whereby a cause of action has arisen. It must therefore consist of an act or agreement, or several acts or agreements having some connection with each other, in which more than one person is concerned, and by which the legal relations of such persons between themselves are altered.

BLACK'S LAW DICTIONARY 1668 (4th ed. 1968) (citations omitted). The IRS' comparison of Section 4971 penalties to transaction-based excise taxes such as gasoline, alcohol, tobacco, wagering, estate and gift taxes is therefore inapposite. The Section 4971 assessments arise from the violation of ERISA, not from lawful transactions.

The IRS argues that the "'transaction' taxed under Section 4971 is the act of maintaining a pension plan that is not funded adequately." (Pet. Rep. 2 n.1). But Section 507(a)(7)(E) grants no priority to taxes on "acts" or "activities." Section 507(a)(7)(E) uses the narrower term "transaction." Where Congress wanted a more inclusive description, it used the phrase "excise taxes imposed on particular *activities* or transactions," 11 U.S.C. § 902(2)(B) (emphasis added), or "transaction or *event* that occurred," 11 U.S.C. § 523(a)(7) (emphasis added).

G. The Decision of the Court of Appeals Comports with the Case Law Under the Bankruptcy Code.

After enactment of the Bankruptcy Code, lower federal courts have continued to follow the Court's pre-Code cases, universally holding that true taxes for purposes of bankruptcy law are pecuniary burdens enacted for the purpose of supporting the

government.[21] Under this definition, some courts have treated federal "taxes" as "penalties" for purposes of priority under the Bankruptcy Code. *See, e.g., United States v. Dumler (In re Cassidy)*, 983 F.2d 161, 162-65 (10th Cir. 1992) (an "income tax" treated as a penalty); *Deluxe Check Printers v. United States*, 15 Cl. Ct. 175, 181 (1988), *aff'd in part, rev'd in part on other grounds sub nom. Deluxe Corp. v. United States*, 885 F.2d 848 (Fed. Cir. 1989) (tax under 26 U.S.C. § 4941 treated as a penalty); *see also Texas Am. Oil Corp. v. United States Dep't of Energy*, 44 F.3d 1557, 1571 (Fed. Cir. 1995) (*en banc*) ("restitution" in Petroleum Overcharge and Distribution Act was partially a penalty for bankruptcy purposes).

Other courts, applying the same *Feiring* test, have found certain federal assessments to be taxes, whether or not referred to as "taxes." *United States v. Unsecured Creditors Comm. of C-T of Va., Inc. (In re C-T of Va., Inc.)*, 977 F.2d 137, 139 (4th Cir. 1992), *cert. denied*, 113 S. Ct. 1644 (1993) (court determined that an "excise tax" under 26 U.S.C. § 4980 was in fact a revenue

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[21] The "*Lorber Industries* test" referred to by the IRS and the lower courts is simply a recent derivative of the *New York* and *Feiring* definitions. *See County Sanitation Dist. No. 2 v. Lorber Indus. of Cal., Inc. (In re Lorber Indus. of Cal., Inc.)*, 675 F.2d 1062, 1066 (9th Cir. 1982) (*citing Feiring*); *In re Farmers Frozen Food Co.*, 221 F. Supp. 385, 387 & n.2 (N.D. Cal. 1963), *aff'd sub nom. Dungan v. Department of Agriculture*, 332 F.2d 793 (9th Cir. 1964) (*citing New York* and *Feiring*). The Reorganized Debtors do not assert that the "*Lorber Industries* test" need be adopted by the Court. However, this line of cases demonstrates the universal acceptance of the *New York* and *Feiring* rationales before and after the enactment of the Bankruptcy Code. The IRS' assertion that *Lorber Industries* involved a user fee and that *United States v. Dumler (In re Cassidy)*, 983 F.2d 161 (10th Cir. 1992) involved an income tax is irrelevant. (IRS Br. 19). These cases defined a "tax" under the Bankruptcy Act and Code, respectively, using the Court's prior decisions. The fact that this case involves a claim to excise tax priority is not a significant distinction. (IRS Br. 19-20).

raising statute for purposes of the Bankruptcy Code); *United States v. River Coal Co.*, 748 F.2d 1103, 1106 (6th Cir. 1984) (a "reclamation fee" under the federal Surface Mining Control and Reclamation Act of 1977 was a tax for bankruptcy purposes); *United States v. Plan Comm. of Juvenile Shoe Corp. (In re Juvenile Shoe Corp.)*, 180 B.R. 206, 208 (E.D. Mo. 1994) ("excise tax" under 26 U.S.C. § 4980 was a tax, in part because it is compensatory).

The reasoning of these cases is sound. Tax penalties are meant "to punish those who fail to abide by the taxing structure, and to deter those who might be inclined to avoid tax payment." *In re Virtual Network Servs. Corp.*, 902 F.2d 1246, 1250 (7th Cir. 1990). In the context of bankruptcy, however, granting priority to claims for prepetition tax penalties would accomplish neither goal; instead, such claims would penalize only other claimants. *Simonson v. Granquist*, 369 U.S. 38, 40-41 (1962). This is particularly true in a case such as this where the former owners of the Debtors, who were responsible to make the pension payments, will receive nothing. Based on the punitive nature of Section 4971, four other cases directly on point have held that IRS claims under Section 4971 are not entitled to priority as a "tax" in bankruptcy. *Seidle v. United States (In re Airlift Int'l, Inc.)*, 120 B.R. 597, 601-02 (S.D. Fla. 1990); *United Steelworkers of Am. v. PBGC (In re Wheeling-Pittsburgh Steel Corp.)*, 103 B.R. 672, 693-94 (W.D. Pa. 1989); *In re Chateaugay Corp.*, 15 Employee Benefits Cas. (BNA) 1237, 1238 (Bankr. S.D.N.Y. Mar. 30, 1992), *rev'd on other grounds sub nom. LTV Corp. v. IRS (In re Chateaugay Corp.)*, 146 B.R. 626 (S.D.N.Y. 1992);[22] *In re Bertsch & Co.*,

[22] Pursuant to a stipulation of the parties, the District Court later vacated its order and the Bankruptcy Court's order in the LTV case. *LTV Corp. v. IRS (In re Chateaugay Corp.)*, 157 B.R. 74 (S.D.N.Y. 1993).

No. IP84-4366RA J, 1988 Bankr. LEXIS 2570, at *6 (Bankr. S.D. Ind. Aug. 15, 1988).[23]

The IRS has cited no decision of the Court, or any decision of any lower court except *United States v. Mansfield Tire & Rubber Co. (In re Mansfield Tire & Rubber Co.)*, 942 F.2d 1055 (6th Cir. 1991), *cert. denied sub. nom. Krugliak v. United States*, 502 U.S. 1092 (1992), holding that labels in a nonbankruptcy federal statute are conclusive of the substance of a claim under the federal bankruptcy laws. Every court addressing this issue since the *Mansfield* decision properly has refused to follow it. *See, e.g., United States v. Dumler (In re Cassidy)*, 983 F.2d 161, 162 (10th Cir. 1992); *United States v. Unsecured Creditors' Comm. of C-T of Va., Inc. (In re C-T of Va., Inc.)*, 977 F.2d 137, 139 (4th Cir. 1992).

H. Granting Tax Priority to Section 4971 Claims Would Prevent Reorganization In Many Cases.

Except for the smallest penalty, *i.e.*, a 10% penalty for the 1989 underfunding, the IRS has abandoned all of its other 10% and 100% "tax" claims. (IRS Br. 3 n.3). The IRS tailored its argument in the Court of Appeals by dropping over $40 million in 10% and 100% "tax" claims even though its argument for "excise tax" priority for those claims was exactly the same as its argument for "excise tax" priority for the single 10% "excise tax" claim that remains. Although this relieves the IRS from arguing in this appeal that the cumulative 10% and 100% claims are entitled to

[23] One other lower court has twice addressed Section 4971 claims in a bankruptcy context. In one case the court granted the claims administrative expense priority, *In re Williams Co.*, 81 B.R. 437, 439 (Bankr. N.D. Ohio 1986) and in another case denied such priority, *In re Overly-Hautz Co.*, 57 B.R. 932, 937 (Bankr. N.D. Ohio 1986), *aff'd*, 81 B.R. 434 (N.D. Ohio 1987). The issue of whether Section 4971 claims are "taxes" for bankruptcy purposes was not raised in either case.

priority as "excise taxes," it does not avoid the reality that the basis for claiming excise tax priority for both is identical.

The IRS also avoids having to justify imposing postpetition penalties for the Debtors' compliance with the Bankruptcy Code by not making postpetition minimum funding payments. As the Bankruptcy Court stated in this case:

> Since the basis for the IRS's proofs of claim for these periods is the Debtors' compliance with the Bankruptcy Code, it would be inequitable to allow the claims. Any failure to make such contribution is protected under bankruptcy law and cannot be penalized by the IRS.

(Pet. 54a).

Acceptance of the IRS' argument would virtually ensure tax priority treatment for prepetition and postpetition 100% penalties for purposes of Sections 507(a) and 503(b) of the Bankruptcy Code. *See Claridge Apartments Co. v. Commissioner*, 323 U.S. 141, 162 (1944) ("The possibility that uniform interpretation may be required gives pause, at least, before adopting a view in this case which, if extended to the other provisions, would open so wide a door . . . .").

As the IRS has stated, "claims asserted under Section 4971 alone accumulate to hundreds of millions of dollars annually." (Pet. Rep. 2). A decision granting such claims priority in bankruptcy cases would devastate the reorganization efforts of companies like CF&I. Former general counsel for the PBGC has written that "[t]he implications of such a holding for debtors and their creditors are obvious--and enormous." Flowe, *Beware Financial Impact of Supreme Court Ruling*, 28 BANKRUPTCY COURT DECISIONS: WEEKLY NEWS AND COMMENT, Jan. 16, 1996, at A1, A8, A10 ("Priority claims of this magnitude could easily cause many reorganizations to become liquidations."). If the IRS were correct, then Chapter 11 reorganization would no longer be possible for a company that cannot afford its pension plan. Voluntary distress termination of a pension plan under 29

U.S.C. § 1341(c)(3)(B)(ii) takes time, particularly in a case like this where a collective bargaining agreement stands in the way of termination. 29 U.S.C. § 1341(a)(3); 11 U.S.C. § 1113(f). During this time, according to the IRS, Section 4971 "taxes" accrue at multiplying 10% and 100% rates. As these "taxes" consume available assets, reorganization becomes impossible.

There is no sound basis for the IRS' fear that every excise tax will be treated as a nonpriority claim in bankruptcy. Courts have already demonstrated an ability to distinguish between an excise tax and a penalty for bankruptcy purposes without prejudicing the legitimate pecuniary interests of the IRS. Only two exactions under Subtitle D, Miscellaneous Excise Taxes, 26 U.S.C. §§ 4941 and 4971 have been found not to be entitled to priority. *See supra* at 22, 35-36. Unlike the "gas guzzler," "ozone depleting chemicals," "golden parachute," and "greenmail" exactions highlighted by the IRS (IRS Br. 16-17), claims under Section 4971 are imposed only upon violation of a statute.

The IRS' and PBGC's assertion that granting priority to Section 4971 claims will coerce pension funding is not logical. (IRS Br. 27-28; PBGC Br. 23-25). Whether the Section 4971 amounts are paid before or after unsecured creditors does not affect the employer's liability or incentive to fund the pension plans. If a pension plan sponsor is insolvent, as in this case, a priority in bankruptcy for unpaid prepetition claims under Section 4971 could have the opposite result by encouraging creditors to initiate premature bankruptcy filings timed to precede upcoming funding payments, a perverse incentive not likely intended by Congress.

II. THE IRS' CLAIMS UNDER SECTION 4971 WERE PROPERLY SUBORDINATED TO THE CLAIMS OF GENERAL UNSECURED CREDITORS.

A. Subordination of the IRS' Claims Was Proper Under the Plan

By focusing on 11 U.S.C. § 510(c), the IRS and the PBGC ignore other provisions of the Bankruptcy Code that required the Plan to classify separately and to subordinate the Section 4971 claims.[24] Before a Chapter 11 plan may be confirmed, Section 1129(a)(7) of the Bankruptcy Code requires that each creditor holding an impaired claim either (i) vote to accept the plan or (ii) receive an amount not less than the creditor would receive if the debtor were liquidated under Chapter 7. 11 U.S.C § 1129(a)(7). The IRS concedes that prepetition penalty claims are automatically subordinated in a Chapter 7 case pursuant to 11 U.S.C. § 726(a)(4). (IRS Br. 28-29). In a liquidating Chapter 11 case such as this one, prepetition penalty claims likewise must be subordinated if an unsecured creditor is to receive as much as under Chapter 7. Thus, while Chapter 7 subordination provisions do not apply directly in Chapter 11 cases, *see* 11 U.S.C. § 103(b), Section 1129(a)(7) requires reference to them in determining whether Chapter 11 plans can be confirmed: "In order to determine the hypothetical distribution in a liquidation [under Section 1129(a)(7)], the court will have to consider the various subordination provisions of proposed 11 U.S.C. 510, 726(a)(3), 726(a)(4). . . ." H.R. Rep. No. 595, 95th Cong., 1st Sess. 412 (1977).[25]

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[24] Federal Rule of Bankruptcy Procedure 7001(8) recognizes that subordination may be provided in a Chapter 11 plan.

[25] Section 726(a)(4) specifies a subordinated fourth priority for claims "for any fine, penalty, or forfeiture, or for multiple, exemplary, or punitive damages, arising before the earlier of the order for relief or the appointment of a trustee, to the extent that such fine, penalty,
(continued...)

The Bankruptcy Court specifically found that, under the provisions of the Plan subordinating the Section 4971 claims, creditors would receive at least as much as if the Debtors were liquidated under Chapter 7. (Pet. 28a). The IRS has not contested this finding. Since the Plan did not pay holders of unsecured claims in full, failure to subordinate the IRS' claims would have been directly contrary to the language of Section 1129(a)(7) and would have prevented confirmation of the Plan. Section 1129(a)(7) is satisfied with respect to the IRS, since its claims would have been subordinated in Chapter 7 and not entitled to a distribution.[26]

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[25](...continued)
forfeiture, or damages are not compensation for actual pecuniary loss suffered by the holder of such claim." In order to comply with Section 1129(a)(7), Class 13 of the Plan matches this language: "This Class consists of all Allowed Claims which are Claims for penalties under any agreement or any applicable law, including, without limitation, all Claims of the IRS pursuant to 26 U.S.C. Section 4971, all Claims of state and local taxing authorities for tax-related penalties, and any other Claims for any fine, penalty or forfeiture, or for multiple, exemplary or punitive damages, to the extent that such Claims are not compensation for actual pecuniary loss suffered by the holders of such Claims." (CF&I R. 141).

[26] In a Chapter 11 case where the debtor continued in business and the debtor's owners retained interests, subordination of nonpecuniary loss penalty claims might not be proper. In Chapter 11 cases such as this, where unsecured creditors will receive less than the full value of their claims and owners receive nothing, there is no valid reason to require that creditors pay nonpecuniary loss penalties. *See Schultz Broadway Inn v. United States*, 912 F.2d 230, 233-34 (8th Cir. 1990) (in a liquidating Chapter 11, nonpecuniary loss penalties should not be treated differently than under Chapter 7). Section 726(a)(4) is not, as the IRS assumes, proof that nonpecuniary loss penalties cannot be subordinated in Chapter 11 cases. The wide range of circumstances possible in Chapter 11 explains why in Chapter 11 cases subordination of nonpecuniary loss penalty claims is left to a case by case determination,
(continued...)

The theme of the IRS' argument against subordination is that a Bankruptcy Court cannot alter statutorily created "categories" of claims. (IRS Br. 12, 24, 25 n.13, 26, 28, 29). The PBGC similarly argues that what occurred here was "reshuffling of the legislated priorities." (PBGC Br. 21). What the IRS and the PBGC overlook is that Chapter 11 nowhere requires a unitary "category" for all general unsecured claims. The lower courts did not, therefore, "disregard categories of priorities specified by statute" (IRS Br. 23), because no such statutory categories for general unsecured claims exist.[27] The IRS recognizes that unlike *United States v. Noland* argued in tandem with this case, its claims here do not have a specific statutory priority. (IRS Br. 9 n.6).

The Bankruptcy Code required separate classification of the Section 4971 claims. Chapter 11 requires a plan to "designate" "classes of claims." 11 U.S.C. § 1123(a)(1). Claims within a class designated by a Chapter 11 plan must be "substantially similar." 11 U.S.C. § 1122(a). General unsecured claims and nonpecuniary loss penalties are not substantially similar because they have different priorities in Chapter 7 and because the former represent a pecuniary loss while the latter do not. Therefore, the Plan in this case could not have placed pecuniary loss and nonpecuniary loss claims in the same class.

The Bankruptcy Court found, and the IRS does not dispute, that the Plan complied with the classification requirements of Chapter 11. (Pet. 27a). The IRS did not challenge the Plan's creation of a separate subordinated class for nonpecuniary loss

[26](...continued)
as opposed to the automatic subordination mandated in every case under Chapter 7.

[27] Chapter 11 "does not require all nonpriority prepetition unsecured claims to be placed within a single class. [T]he Code . . . implicitly recognizes that separate classification of unsecured claims may be appropriate." 5 COLLIER ON BANKRUPTCY ¶ 1122.03[4], at 1122-11 to 1122-12 (15th ed. 1995).

claims, limiting its arguments to the inclusion of its Section 4971 "tax" claims in that class. Yet if, as the lower courts found, the IRS' Section 4971 claims are not entitled to priority as taxes, there is no basis for exempting the IRS from the provisions of the Bankruptcy Code or treating its nonpecuniary loss penalty claims better than like claims of other creditors.[28]

Furthermore, if the Section 4971 claims had been classified with other unsecured creditors, the Bankruptcy Code would have required that they be treated equally with other claims in the class, 11 U.S.C. § 1123(a)(4), thereby making it impossible to meet the requirements of Section 1129(a)(7). Accordingly, separately classifying and providing subordinated treatment for nonpecuniary loss penalty claims in a case such as this was both necessary and proper.

Disputes over separate classification of claims in a Chapter 11 plan are resolved not only by the requirements of Section 1129(a)(7) but also by the "unfair discrimination" and "fair and equitable" tests of 11 U.S.C. § 1129(b). *Steelcase, Inc. v. Johnson (In re Johnson)*, 21 F.3d 323, 328 (9th Cir. 1994); 5 COLLIER ON BANKRUPTCY, ¶ 1122.04, at 1122-22 (15th ed. 1995). The Bankruptcy Court found that each of these requirements was satisfied under the Plan (Pet. 27a-29a) because failure to subordinate nonpecuniary loss penalty claims would have punished creditors who suffered pecuniary losses for the Debtors'

[28] *See Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33, 58-59 & n. 14 (1989) ("By submitting a claim against the bankruptcy estate, creditors subject themselves to the court's equitable power to disallow those claims . . . . "); *cf. United States v. Whiting Pools, Inc.*, 462 U.S. 198, 209 (1983) (IRS is bound by § 542(a) of the Bankruptcy Code "to the same extent as any other secured creditor").

violation of ERISA funding requirements.[29] These findings are unchallenged.

B. **Subordination of the IRS' Claims Was Proper Under Bankruptcy Code Sections 510(c) and 502(j).**

The lower courts also properly subordinated the IRS' claims under Section 4971 pursuant to the equitable powers conferred on the Bankruptcy Court under 11 U.S.C. §§ 510(c) and 502(j). The Bankruptcy Court found that allowing the IRS the same distributive priority as the PBGC and other general unsecured creditors would advance neither the legislative purpose of Section 4971 nor the principle of equality of distribution that underlies the Bankruptcy Code. Instead it would punish creditors. (Opp. 4a).[30]

[29] Separate classification of nonpecuniary loss penalty claims in a case lacking sufficient assets to pay pecuniary loss claims is also fair because nonpecuniary loss claims contributed nothing to the value of the assets. *See In re Four Seasons Nursing Ctrs. of Am., Inc.*, 472 F.2d 747, 750 (10th Cir. 1973) (approving plan's subordinated class of interests that "introduced no fresh money and did not directly or indirectly contribute substance to either the debtor corporation or the reorganized corporation."); *cf.* 3 COLLIER ON BANKRUPTCY ¶ 57.22[1], at 382 (14th ed. 1977) ("[T]here is an undeniable equity in the postulate that participation in the estate should be denied to a creditor who has neither in some degree contributed to the distributable funds . . . nor has suffered a pecuniary loss by parting with something in money's worth.") (discussing disallowance of penalties under former law).

[30] *Cf. Simonson v. Granquist*, 369 U.S. 38, 40-41 (1962) ("[T]he prohibition of all tax penalties in bankruptcy [under former law] is wholly consistent with the policy of the penalty provisions themselves. Tax penalties are imposed at least in part as punitive measures against persons who have been guilty of some default or wrong. Enforcement of penalties against the estates of bankrupts, however, would serve not to punish the delinquent taxpayers, but rather their entirely innocent creditors."); *Young v. Higbee Co.*, 324 U.S. 204, 210 (1945)
(continued...)

The Court's equitable subordination decisions in *Comstock v. Group of Institutional Investors*, 335 U.S. 211 (1948), *Pepper v. Litton*, 308 U.S. 295 (1939), and *Taylor v. Standard Gas & Electric Co.*, 306 U.S. 307 (1939) did not address subordination of governmental nonpecuniary loss penalty claims because the Bankruptcy Act disallowed such claims. 11 U.S.C. § 93(j) (repealed 1978); *Simonson v. Granquist*, 369 U.S. 38, 40-41 (1962).[31]

Equitable subordination in *Pepper* and *Taylor* protected innocent creditors from harm by subordinating the claims of creditors who violated fiduciary obligations and mismanaged corporate affairs. Subordination of the IRS' claims in this case also protected innocent creditors from harm by refusing to punish them for the Debtors' violation of ERISA.

[30](...continued)
("[H]istorically one of the prime purposes of the bankruptcy law has been to bring about a ratable distribution among creditors of a bankrupt's assets; to protect the creditors from one another."); *Sampsell v. Imperial Paper & Color Corp.*, 313 U.S. 215, 219 (1941) ("[T]he theme of the Bankruptcy Act is equality of distribution.").

[31] The IRS cites no pre-Code precedent refusing to subordinate a nonpecuniary loss penalty. The IRS erroneously implies that no pre-Bankruptcy Code cases subordinated claims on grounds other than inequitable conduct. *But see Jezarian v. Raichle (In re Stirling Homex Corp.)*, 579 F.2d 206, 212-13 (2d Cir. 1978) (subordinating claims of innocent defrauded stock purchasers to those of general unsecured creditors); *In re Four Seasons Nursing Ctrs. of Am., Inc.*, 472 F.2d 747, 750 (10th Cir. 1973) (approving separate classification and subordination under plan of purchasers of common stock, based on date of purchase). The Court's opinion in *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156 (1946), denying interest on interest a reorganization court ordered not to be paid, has been regarded by the Court of Appeals for the Fifth Circuit as a subordination decision. *Fahs v. Martin*, 224 F.2d 387, 395 n.5 (5th Cir. 1955).

In *Pepper*, the Court noted that bankruptcy courts traditionally exercised their equitable powers "to the end that fraud will not prevail, that substance will not give way to form, that technical considerations will not prevent substantial justice from being done." 308 U.S. at 305. While the present case does not involve fraud or violation of fiduciary obligations, it does involve the assertion by the IRS that the form (*i.e.*, the label) of its claim must prevail over its substance, and that technical considerations (*i.e.*, exacting a penalty incurred by and directed at the Debtors when the Debtors are liquidated and only creditors can pay) must prevail over substantial justice, as specifically determined by the Bankruptcy Court on the facts of this case. The Court of Appeals' decision in this case is therefore not a departure from established precedent, but instead an application of equitable principles in a factual setting which had not arisen under prior law.

Comstock stands for the principle that *Pepper* and *Taylor* do not require subordination of a claim where (i) subordination "would unjustly enrich" the objecting creditors, (ii) the challenged claim "was the outgrowth of complicated but legitimate good faith business transactions," (iii) neither the "design or effect of the transaction produced injury to the [objecting creditor] or the interests for which he speaks," and (iv) the claimant's actions were "established as beneficial rather than injurious to the interests which now challenge them." 335 U.S. at 229-230. *Comstock* in no way forbids subordination of the IRS' penalty claims in this case where the Bankruptcy Court found that their payment "would defeat any attempt by the Debtors to reorganize, would prevent any return to creditors[,] . . . would provide a windfall to the IRS [, and] . . . would harm the parties that are intended to be protected by the pension plan that section 4971 seeks to enforce, because payment of section 4971 penalty claims would be at the expense of prepetition unsecured creditors including pensioners." (Pet. 51a).

The Bankruptcy Code did not remove the traditional powers of Bankruptcy Courts to allow or disallow claims, reject claims in

whole or in part, or subordinate claims in light of equitable considerations. Section 502(j), which permits reconsideration and allowance or disallowance "according to the equities of the case," is the statutory successor of Section 57k of the Bankruptcy Act.[32] The Court in *Pepper* read Section 57k as follows: "For certainly if, as provided in the latter section, a claim which has been allowed may be later 'rejected in whole or in part, according to the equities of the case,' disallowance or subordination in light of equitable considerations may originally be made." 308 U.S. at 305. Section 502(j) grants the same powers that include, as *Pepper* reasoned, the power to subordinate claims in the first instance based on the "equities of the case."

Section 510(c) expressly permits subordination of claims "for purposes of distribution" based on "principles of equitable subordination." The Court of Appeals correctly rejected the IRS' nontextual arguments for limits on Section 510(c). The text of Section 510(c) does not require a finding of inequitable conduct[33] or freeze principles of equitable subordination in time by forever terminating the power of courts to make precedents as new circumstances arise.[34]

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[32] Here, the IRS' claims were "deemed allowed" when filed, subject to objection and reconsideration. 11 U.S.C. § 502(a).

[33] The Courts of Appeals are in unanimous agreement with the Court of Appeals in this case that, in the narrow context of nonpecuniary loss penalties, equitable subordination under 11 U.S.C. § 510(c) does not require a finding of inequitable conduct. *United States v. Noland (In re First Truck Lines, Inc.)*, 48 F.3d 210, 218 (6th Cir. 1995), *cert. granted*, No. 95-323 (Dec. 1, 1995); *Burden v. United States*, 917 F.2d 115, 120 (3d Cir. 1990); *Schultz Broadway Inn v. United States*, 912 F.2d 230, 233 (8th Cir. 1990); *In re Virtual Network Servs. Corp.*, 902 F.2d 1246, 1250 (7th Cir. 1990).

[34] The history of creditors' rights in liquidation demonstrates that equitable principles are capable of growth. *See* GLENN, THE LAW GOVERNING LIQUIDATION § 554, at 798 (1935) (With reference to

(continued...)

Section 502(j) and Section 510(c) specify that reconsideration or equitable subordination are to be based on "equities of the case" and "principles of equitable subordination." The phrase "principles of equitable subordination" was drafted to permit judicial development:

> It is intended that the term "principles of equitable subordination" follow existing case law and leave to the courts development of this principle. To date, under existing law, a claim is generally subordinated only if [the] holder of such claim is guilty of inequitable conduct, *or the claim itself is of a status susceptible to subordination, such as a penalty* . . . .

124 Cong. Rec. 33,998 (1978) (statement of Rep. Edwards) (emphasis added); *id.* 32,398 (statement of Sen. DeConcini).[35]

All Courts of Appeals considering this issue have concluded that prepetition penalty claims not involving pecuniary losses may be equitably subordinated.[36] With only one exception known to

[34](...continued)
development of equitable rules concerning tracing of trust funds in bank failures, "Sir George Jessel took pains to say, in his judgment in the great case of Hallett's Estate [*Knatchbull v. Hallett (In re Hallett's Estate), 13 Ch. D. 696 (C.A. 1880)*], that equity was capable of growth, and was growing in his time.").

[35] The IRS' summary of the legislative history of Section 510(c) omits the express reference to subordination of penalties. (IRS Br. 25 n. 13). Even the portion of the report quoted by the IRS clearly states that "a claim *normally* may be a portion of the subordinated only it its holder is guilty of misconduct." (*Id.*) (emphasis added). This obviously leaves the door open for equitable subordination in the narrow class of claims for nonpecuniary loss penalties.

[36] *See, e.g., Burden v. United States,* 917 F.2d 115, 120 (3d Cir. 1990) (federal tax penalty may be subordinated); *Schultz Broadway Inn v. United States,* 912 F.2d 230, 234 (8th Cir. 1990) (federal tax penalties (continued...)

the Reorganized Debtors,[37] the federal courts addressing the precise issue have held that Section 4971 penalty claims should be equitably subordinated under Section 510(c), whether or not the taxing authority engaged in any misconduct. *See Seidle v. United States (In re Airlift Int'l, Inc.),* 120 B.R. 597, 601-02 (S.D. Fla. 1990); *In re Chateaugay Corp.*, 15 Employee Benefits Cas. (BNA) 1237, 1238-39 (Bankr. S.D.N.Y. Mar. 30, 1992), *rev'd on other grounds sub nom. LTV Corp. v. IRS (In re Chateaugay Corp.),* 146 B.R. 626 (S.D.N.Y. 1992); *In re Bertsch & Co.,* No. IP84-4366RA J, 1988 Bankr. LEXIS 2570, at *6-7 (Bankr. S.D. Ind. Aug. 15, 1988). Applying traditional equitable considerations and long-standing principles of bankruptcy law to the narrow context of nonpecuniary loss penalty claims, these courts correctly concluded that nonpecuniary loss penalty claims under Section 4971 should be subordinated so as to avoid loss to the general unsecured creditors who suffered pecuniary loss.

[36](...continued)
subordinated); *In re Virtual Network Servs. Corp.*, 902 F.2d 1246, 1250 (7th Cir. 1990) (punishing "innocent creditors because of [the debtor's] wrongful conduct serves no purpose").

[37] The solitary anomaly is *United States v. Mansfield Tire & Rubber Co. (In re Mansfield Tire & Rubber Co.),* 942 F.2d 1055 (6th Cir. 1991), *cert. denied sub. nom. Krugliak v. United States,* 502 U.S. 1092 (1992), which is of questionable value as a precedent on the issue of subordinating tax penalties in view of that Court's aberrational holding that the Section 4971 liabilities were not penalties.

CONCLUSION

The judgment of the Court of Appeals should be affirmed.

Respectfully submitted.

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